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4/18/05
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Respondent's Ex. G

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois Commerce Commission
On Its Own Motion,

v.

The Peoples Gas Light and Coke Company

01-0707

Reconciliation of revenues
collected under fuel and gas
adjustment charges with actual
costs.

OFFICIAL FILE

I.C.C. DOCKET NO. 01-0707

Peoples Exhibit No. 2

Witness Zack

Date 4/18/05 Reporter TR

REBUTTAL TESTIMONY
OF
THOMAS E. ZACK

- 1 Q. Please state your name and business address.
- 2 A. Thomas E. Zack, 150 North Michigan Avenue, Chicago, Illinois 60601.
- 3 Q. By whom are you employed?
- 4 A. The Peoples Gas Light and Coke Company ("Peoples Gas," the
- 5 "Company" or "Respondent").
- 6 Q. What position do you hold with Peoples Gas?
- 7 A. I am Director of Gas Supply.
- 8 Q. What are your responsibilities in that position?
- 9 A. My present responsibilities include directing the activities of the Gas
- 10 Supply Planning, Gas Supply Administration, Gas Control and Gas Storage
- 11 Departments for both Respondent and North Shore Gas Company.

12 Q. Please summarize your educational background and experience.

13 A. In 1983, I received my Bachelor of Arts degree, with majors in Accounting
14 and Business Administration, from St. Ambrose University in Davenport, Iowa. In
15 1986, I received a Masters of Business Administration, with a concentration in
16 Finance, from DePaul University.

17 I began my employment with Peoples Gas in 1984 in the Auditing
18 Department. In 1986, I transferred to the Financial Reporting Department. In
19 1988, I transferred to the Rate Research and Policy Department. Four years
20 later I transferred to the Office of Corporate Planning. In November 1996, I
21 transferred to the Rates Department as a Supervisor. In September 1997, I was
22 promoted to Manager of the Rates Department. In October 2000, I was
23 promoted to Director, Customer Relations. In March 2003, I transferred to the
24 position of Director, Gas Supply.

25 Q. What are the issues in this proceeding?

26 A. The issues in this proceeding include the following:

- 27 • the prudence of Respondent's hedging strategy
- 28 • the prudence of the Gas Purchase and Agency Agreement ("GPAA")
- 29 • the prudence of certain off-system transactions
- 30 • use of Respondent's Manlove storage field and the rate treatment of
- 31 hub services
- 32 • the appropriate accounting treatment for maintenance gas
- 33 • the adequacy of Respondent's internal controls for gas purchasing and
- 34 management

- 35 • whether the intercompany services agreement needs to be amended
- 36 • the appropriateness of the storage optimization contract

37 Q. What is the purpose of your testimony?

38 A. The purpose of my testimony is to refute, generally, allegations from the
39 Illinois Commerce Commission Staff and intervenors that: (1) Respondent did
40 not have an appropriate hedging strategy; (2) the process that led to and support
41 for the GPAA were flawed; (3) rate treatment of federal jurisdictional interstate
42 services -- what Respondent calls hub services -- is inappropriate and
43 detrimental to customers; (4) Respondent's internal controls for gas purchasing
44 and management are inadequate; and (5) the intercompany services agreement
45 needs to be amended.

46 Other witnesses address these issues in more detail in their rebuttal
47 testimony. Specifically, Mr. Frank Graves shows that Respondent's hedging
48 policies were reasonable and appropriate under the business conditions and
49 regulatory climate that existed at the time hedging decisions for the 2000-2001
50 winter were made. Messrs. Graves and David Wear show that the GPAA and
51 costs incurred under it were prudent. Mr. Wear also demonstrates that an off-
52 system transaction at issue (Transaction No. 19) was a reasonable operational
53 decision, and Respondent's use of storage and related hub services are
54 beneficial to customers. In addition, Mr. Wear addresses maintenance gas and
55 the storage optimization contract. Mr. Thomas Puracchio addresses the
56 capabilities and characteristics of Respondent's Manlove storage field in
57 response to allegations about Respondent's use and maintenance of that field.

58 He shows that hub services have been beneficial to the field's operations and
59 have enhanced the reliability of service to gas charge customers. Ms. Grace
60 describes how storage costs are reflected in the Gas Charge to pass through to
61 customers the benefit of winter/summer price differentials and explains how
62 refund amounts that Respondent is not contesting would be handled through the
63 Gas Charge if the Illinois Commerce Commission ("Commission") so orders.

64 Q. Please summarize your testimony.

65 A. First, my testimony will address policy matters that the Commission should
66 consider in making its decision in this proceeding. Second, my testimony will
67 describe how the magnitude of the proposed disallowances, in and of
68 themselves, is unreasonable. Third, I will discuss some of the problems with the
69 disallowance proposals related to the Gas Purchase and Agency Agreement.
70 Fourth, I will address the inappropriateness of Staff's position regarding the
71 interstate hub transactions. Fifth, I will respond to Staff's audit recommendations
72 and questions as to internal controls. Finally, I will respond to Staff's assertion
73 that the Company undertook certain transactions that were inappropriate as they
74 were inconsistent with the intercompany services agreement.

75 Q. What are the policy matters that the Commission should consider in this
76 proceeding?

77 A. First, the Commission, from a policy standpoint, should consider the need
78 for consistency in regulation. There are two aspects of this principle --
79 consistency with the Commission's treatment of the Company in prior cases and
80 consistency vis-à-vis other utilities. Second, the Commission should carefully

81 examine the departure of the proposed disallowances from the prudence
82 standard. That is, the Commission should be closely guarding against proposals
83 that are based solely on hindsight review and mere difference of opinion. Third,
84 the Commission should consider the extremely punitive nature of the amounts of
85 the proposed disallowances in this proceeding.

86 Q. Please elaborate on the principle of consistency.

87 A. Several Staff and intervenor recommendations are based on theories that
88 are contrary to well-established Commission policies. As a regulated utility,
89 Respondent necessarily relies on prior Commission orders and statements, such
90 as notice of inquiry reports, to guide its decision making. It would be troubling if
91 good faith reliance on those orders and statements did not afford substantial
92 confidence that decisions consistent with those orders and statements would
93 withstand after the fact regulatory scrutiny. As examples:

94 1. The Commission has consistently not required utilities to financially hedge
95 gas supplies and has not imposed an obligation to mitigate price volatility
96 through the use of financial hedging. Yet, some of the same parties who
97 raised these issues in the past, and lost, are back again in this case and
98 making the same recommendations.

99 2. The agreement the Company had executed with Enron was in effect in
100 fiscal year 2000 and Respondent's fiscal year 2000 gas costs were found
101 prudent by the Commission. Neither Staff nor intervenors raised any
102 concerns about the agreement during the 2000 proceeding. However,
103 Staff and intervenors in this case are taking positions that would be

104 inconsistent with the Commission's order in that proceeding. Moreover,
 105 Staff's recommendation is based on requiring the Company to have
 106 performed an analysis of a sort that the Commission has not required in
 107 the past.

108 3. Respondent's hub activities, which have been taking place since 1998 and
 109 involve hundreds of transactions, have never been found imprudent or
 110 inappropriate in past cases. However, now they are suddenly questioned
 111 by the Staff when gas prices spiked higher.

112 It is unreasonable to make utilities operate in an environment where
 113 previous decisions and stated positions cannot be relied upon for direction. It
 114 implies that "reasonable people" would pay no attention to previous Commission
 115 decisions. In the past, financial analysts have viewed Illinois as a reasonable
 116 regulatory climate, but acceptance of the proposals of the Staff and intervenors,
 117 which depart from findings already made by the Commission, would jeopardize
 118 that viewpoint.

119 Q. Please explain your point regarding the need for consistent treatment with
 120 other utilities.

121 A. With minor exceptions, the Commission has made the determination that
 122 other Illinois gas utilities were prudent in their gas purchases without subjecting
 123 them to the severe hindsight review being proposed by the intervenors in this
 124 docket. The Commission already issued orders for all Illinois utilities' 2000
 125 reconciliation cases. Except for Respondent and North Shore Gas Company,
 126 those cases include the months October - December 2000, which was a period

127 of relatively high gas costs. The Commission required only minor cost
128 disallowances in two cases. No disallowance proposals related to financial
129 hedging were made by Staff or intervenors or ordered by the Commission. A
130 disallowance for Illinois Power (Docket 00-0714) was almost entirely overturned
131 by the courts, with only a \$3,000 disallowance remaining. The other
132 disallowance was in the CILCO (Docket 00-0710) case where the Commission
133 ordered a \$49,120 disallowance for revenue received for management services
134 for off-system transactions to be credited back to the gas charge. These two
135 disallowances equated to less than 1/10 of 1% of the respective total gas costs.
136 Neither of these disallowances were based on a decision not to use financial
137 hedges, which is the theory underlying the entire adjustment proposed by Mr.
138 Herbert and approximately one-half of the Citizens Utility Board's ("CUB")
139 recommendation.

140 Likewise the Commission has already issued orders in 9 of the 14 gas
141 charge reconciliation cases for 2001. There were no gas cost disallowances in
142 those 9 cases. In the remaining cases (excluding Respondent and North Shore
143 Gas Company), the Staff has recommended disallowances that are being
144 contested, but none are for financial hedging. (I am also excluding Northern
145 Illinois Gas Company from my discussion because it had a gas cost PBR in
146 effect during the 2000 and 2001 years, and it was not subject to traditional
147 prudence review.)

148 Q. Specifically with respect to hedging, what guidance had the Commission
149 provided regarding the use of financial hedging going into Respondent's fiscal
150 year 2001?

151 A. Mr. Graves addresses this at length in his rebuttal testimony. However, I
152 note that in the Commission's Order for Respondent's fiscal year 1997
153 reconciliation proceeding (Docket 97-0024), which was issued on January 26,
154 2000, in rejecting Mr. Brian Ross' proposed adjustment, the Commission stated:
155 "Clearly, the Commission has not created an obligation or responsibility to
156 mitigate price volatility through the use of such financial tools and we decline to
157 do so in his proceeding." According to the Order, Staff witness Zuraski stated in
158 that same proceeding that, "[i]n his opinion hedging is not inherently better than
159 speculating. ... Furthermore, he posited that hedging is unnecessary in the case
160 of consumers that tend to purchase natural gas through the PGA. ... Finally, Staff
161 urged the Commission not to order the Company to hedge more of its gas supply
162 or to threaten a disallowance if hedging were not done to the extent discussed in
163 Mr. Ross' testimony."

164 This was the last reconciliation case order issued for Respondent prior to
165 the pending reconciliation period and prior to when financial hedges for 2001
166 would had to have been purchased. With this guidance by the Commission, it
167 was clearly reasonable for the Company not to use financial hedging that was
168 outside of its strategy and which it was not required to use.

169 Q. Please explain what you mean when you say that the Commission should
170 carefully examine the departure of the proposed disallowances from the
171 prudence standard.

172 A. Many of the witnesses quote the correct description of the prudence
173 standard. However, they don't seem to want to apply the standard. As I will
174 elaborate in connection with my testimony on the GPAA, those proposed
175 adjustments are not based on the proper application of the prudence standard.
176 For example, two witnesses propose a standard of "superiority," not
177 reasonableness (see, for example, page 10 of Mr. Anderson's direct testimony
178 and page 29 of Dr. Rearden's direct testimony). Also, given the fact that there
179 were no proposed adjustments related to the GPAA in fiscal year 2000, but
180 rather the adjustments were not proposed until after all of the negative publicity
181 about Enron emerged, the proposed adjustments appear to be hindsight in
182 nature. Finally, the prudence standard requires more than a mere difference of
183 opinion. However, when one reviews the small magnitude of the proposed
184 disallowances (approximately \$9 million) in relation to the total gas costs under
185 the GPAA in fiscal year 2001 (approximately \$570 million), it appears that this
186 does not even rise to a difference of opinion. Moreover, even when one looks at
187 the supposed before-the-fact prudence review, the approximately \$30 million
188 calculated by Dr. Rearden (at the least, an overstatement as demonstrated by
189 Messrs. Graves and Wear) compared to the potential total cost of the GPAA over
190 the five-year term, over \$2 billion, the matter still does not rise above the level of
191 a mere difference of opinion.

192 **Magnitude of Proposed Disallowances**

193 Q. The City of Chicago witness, John Herbert, recommended a cost
194 disallowance of approximately \$230 million. Is a disallowance of that magnitude
195 reasonable?

196 A. No, the proposed disallowance is unreasonable and punitive on its face.
197 First, the proposal represents 26% of total gas costs for the reconciliation year.
198 Second, the proposal is grossly disproportionate to Respondent's net income in
199 the reconciliation year. It exceeds the Company's net income not only for fiscal
200 year 2001, but for subsequent periods as well. Third, the comparison to
201 expected fiscal year 2003 savings from financial hedging is inappropriate.

202 Q. Are these comments equally applicable to CUB's recommended
203 disallowance?

204 A. Yes. CUB's two witnesses recommend nearly a \$110 million
205 disallowance. While only about one-half of the City's proposal, the
206 recommendation is still clearly unreasonable and punitive.

207 Q. Why is the size of the recommended adjustment relative to total gas costs
208 significant?

209 A. Mr. Herbert's and Mr. Ross's proposed adjustments both assume
210 substantially lower winter period gas costs. Such a reduction would generally
211 have driven Respondent's gas costs well below that of other Illinois utilities
212 during the winter months. As I have previously pointed out, these utilities were
213 not subjected to the extreme disallowances being proposed in this proceeding.

214 Q. You stated that Mr. Herbert's recommendation was an amount that is
215 grossly disproportionate to Respondent's fiscal year 2001 net income. Why is
216 this relevant?

217 A. I raise this point to respond to a misleading comparison in Mr. Herbert's
218 testimony. Mr. Herbert, on page 56 of his direct testimony, claimed to provide
219 context for his proposed disallowance by comparing it with Respondent's fiscal
220 year 2001 revenues. That comparison is inappropriate because utility revenues
221 include base rate revenues, gas charge revenues and utility taxes. If one were to
222 make a comparison of this sort, a more apt comparison would be to net income.
223 The Company's net income in 2001 was only \$75 million. Both the proposed City
224 disallowance and the CUB recommendations are far out of proportion to that
225 figure. Basically, the City and CUB propose to wipe out the Company's entire
226 profit for more than one year. The Company is only allowed, at most, dollar for
227 dollar recovery of its gas costs. There is no opportunity to make a profit on the
228 buying and selling of natural gas.

229 Q. You stated that Mr. Herbert's comparison to Respondent's estimated fiscal
230 year 2003 savings from hedging was inappropriate. Why?

231 A. As a prefatory matter, I note that Mr. Herbert's testimony referred to
232 Respondent's fiscal year 2002. In fact, the savings he quoted are Respondent's
233 estimate for fiscal year 2003. In any event, his comparison does not provide any
234 support for the recommendation in this proceeding. First, as discussed above
235 and in Mr. Graves' rebuttal testimony, the comparison is not relevant because the
236 regulatory climate in Illinois with respect to financial hedging was very different in

237 fiscal year 2003 than fiscal year 2001. Second, there is nothing to support the
238 conclusion that the two figures -- Mr. Herbert's recommended disallowance and
239 the \$140 million savings -- are comparable in any way.

240 Q. CUB witness Brian Ross, at page 14 of his direct testimony, claimed that
241 Respondent has "no built in incentive, through exposure to price risk" to manage
242 gas price volatility. Please comment on Mr. Ross' assertion.

243 A. Mr. Ross simply demonstrates that he misses the point. Guided by the
244 Commission's statements and orders, the Company understood its task going
245 into fiscal year 2001 to be minimizing gas costs, not volatility, while providing
246 safe and reliable service. The Company has significant incentives to manage its
247 gas costs. The Company's operating expenses increase with increased gas
248 costs. Examples of such cost increases due to increased gas costs are
249 increased borrowing costs to purchase the gas, increased customer service
250 activities and increased uncollectibles (bad debt). The most significant of these
251 is bad debt. Unlike the gas costs themselves, these expenses do not have an
252 ongoing recovery process to be recouped. Rather, a representative amount of
253 these expenses are determined in a rate case and recovered through base rates
254 based on assumptions made at the time of the rate case. In the case of the
255 Company, these rates were established in its last rate case in 1995.

256 In fiscal year 2001, actual gas costs totaled \$884 million. Due to the lag in
257 writing off receivables, the carry over effect of this high priced year led to bad
258 debt write-offs in fiscal year 2002 of \$54 million and about \$43 million in fiscal
259 year 2003. Given that the Company's net income in fiscal years 2002 and 2003

260 were only \$78 million and \$80 million respectively, these cost increases due to
261 bad debt are extremely detrimental to the Company.

262 It is clear that the Company has an incentive to keep gas costs low,
263 consistent with its obligation to provide safe and reliable service.

264 Q. Was gas price volatility a consideration for the Company for fiscal year
265 2001?

266 A. While the Company's focus is on minimization of gas costs, it does not
267 ignore volatility. The Company owns and leases significant amounts of storage
268 to mitigate the need for purchases in winter periods and to take advantage of
269 normally favorable summer/winter price differentials. The Commission has
270 consistently found our storage practices to be prudent. The Company continued
271 to hedge winter prices through its use of storage. About half of normal winter
272 retail sales requirements are provided via storage. Had the Company not utilized
273 storage to hedge, winter gas charges would have been significantly higher.
274 Accordingly, the Company's storage was an effective hedge in fiscal year 2001,
275 as demonstrated by Mr. Wear, who calculated a benefit to customers from
276 storage of approximately \$130 million.

277 Given the Commission's lack of encouragement for utility financial
278 hedging, early financial hedging activities were very measured. Since initial
279 hedging practices started, strategies for hedging have been evolving.

280 The Company's Price Protection Strategy dated August 1998 was driven
281 by target prices for locking in hedged volumes. (Both Mr. Ross and Mr. Herbert
282 incorrectly describe the document and a successor strategy as prepared by a

283 consultant. The price protection strategy was prepared by the Company.) With
284 the significant increase in prices leading into the winter of 2000-2001, the
285 targeted price levels were never hit.

286 Q. Is it clear that in order to gain some price stability, customers are willing to
287 pay the cost of hedging?

288 A. No. It seems only clear that after the fact, if prices could have been lower
289 by hedging, customers would have wanted the lower price. But throughout 2001,
290 and since the late 1980s, the Company's commercial and industrial customers,
291 as well as many residential customers (multi-unit dwellings), have had the
292 opportunity to pursue fixed prices options with another supplier through the
293 various transportation programs the Company offers. The vast majority of those
294 with that choice, have chosen to remain under the Company's Gas Charge.
295 More than 75% of commercial customers have elected to stay with the utility for
296 their gas supply, though they all had the option to transport their own gas. The
297 interest in switching to another supplier for that price stability has been minimal.

298 **Gas Purchase and Agency Agreement**

299 Q. Are the proposed hedging adjustments the only examples of proposed
300 adjustments seeking inconsistent treatment?

301 A. No, the proposed adjustments related to the GPAA also seek an
302 inconsistent treatment from the Commission. Moreover, these proposals suffer
303 from an improper application of the Commission's prudence standard.

304 Q. What is the inconsistency?

305 A. As I previously testified, the GPAA was in effect in fiscal year 2000. No
306 party proposed a disallowance related to that agreement, and the Commission
307 approved the Company's reconciliation of gas costs and revenues for that fiscal
308 year.

309 Q. You testified previously that the Gas Purchase Agency Agreement was in
310 effect during fiscal year 2000. In the reconciliation case for that fiscal year, did
311 the Commission Staff request the sort of study advocated by Dr. Rearden in this
312 proceeding?

313 A. No. Moreover, in prior cases, Respondent has generally supported its
314 portfolio of supply and capacity contracts in much the same manner as it has
315 done in this case. In past reconciliation years, Staff has found the Company's
316 purchase practices and support for those decisions to be prudent. It has never
317 been asked to produce the type of study that Dr. Rearden included with his
318 testimony. Moreover, for the reasons discussed by Mr. Graves, such a study is
319 not a necessary part of evaluating the prudence of a gas supply agreement.
320 Again, this creates the problem of inconsistency that the Commission should
321 avoid.

322 Q. The Staff witnesses concluded in several instances that some aspect of
323 the GPAA is not "superior" to Respondent's historical practices (see, for example,
324 page 10 of Mr. Anderson's testimony and page 29 of Dr. Rearden's testimony).
325 Is it your understanding that prudence requires a utility's performance each year
326 to be superior to what it achieved in prior years?

327 A. Although prudence is a legal standard and Respondent will address this
328 issue in its briefs, it is my understanding that prudence is basically a test of
329 reasonableness and does not require decisions to produce results that are
330 superior to the result that may have been produced by a different approach or
331 superior to what Respondent achieved in prior years. My understanding is that
332 prudence is based on what would have been reasonable based on information
333 known at the time decisions were made. Respondent has shown that the GPAA,
334 as well as Respondent's other gas costs, meet this standard and that following
335 Respondent's prior practices would not have been a better approach to
336 addressing the circumstances that existed when the Company was negotiating
337 the GPAA. While Respondent strives to improve its processes and results and
338 produce superior results, it is my understanding that this is not the basis for
339 evaluating gas costs in a reconciliation proceeding. Again, from a consistency
340 standard, I do not believe the Commission has previously demanded that
341 Respondent or any other utility meet such a standard.

342 Q. Would you please comment on the magnitude of the Staff's and the
343 Attorney General ("AG") witness David Effron's proposed disallowances for the
344 GPAA in light of the prudence standard of reasonableness?

345 A. While Messrs. Wear and Graves will address their recommendations in
346 detail, I do have a general comment about the proposals. As Staff points out,
347 Respondent paid approximately \$570 million in gas costs to ENA. Yet, Staff's
348 proposed disallowance is a bit less than \$9 million. Mr. Effron's proposed
349 disallowance, which he attributes to the GPAA, is \$8.1 million; in fact, much of his

proposal is based on conjecture that an off-system transaction (Transaction No. 19) is somehow related to the GPAA. In other words, Staff's proposal represents only about 1.6% of the GPAA costs, and the AG's proposal is even less. If Transaction No. 19 were considered separately, as it should be, and not artificially tied to the GPAA, the AG's GPAA-related recommendation would have been \$2.6 million, which is less than ½% of the payments to ENA in fiscal year 2001. These percentages would be even lower if one included gas costs for fiscal year 2000 and the zero disallowances determined in that reconciliation case. Specifically, for the two-year period, the recommended disallowances total about \$9 million and total costs under the GPAA were about \$900 million. Let me use an analogy to put this into context. If a consumer went to the grocery store and bought an item for \$1.00 and a similar item was available at another store down the street for 99¢, using Staff and Mr. Effron's relative comparison, they would have called that purchase imprudent.

Moreover, both analyses address only contract features that the witnesses believed could be quantified. No consideration is factored in for other contract terms that provide other benefits. Such relatively small proposed adjustments in the context of a complex contract represent a difference of opinion about the costs and benefits of the contract and belie Staff's and the AG's strident conclusions that the GPAA is clearly imprudent. Moreover, Staff's "before-the-fact" review looked at only a single scenario that was possible at the time the GPAA was entered into -- clearly there was not a single scenario that every

372 reasonable person agreed to at that time. Messrs. Wear and Graves discuss this
373 in more detail in their testimony.

374 Q. Mr. Lounsberry, on pages 4-5 of his direct testimony, stated that Staff had
375 inadequate time to review the GPAA in fiscal year 2000. Please comment.

376 A. That is clearly not supported by the record in that case. During that case
377 (Docket 00-0720), Staff did not ask the Administrative Law Judge for additional
378 time. While the Commission and the Administrative Law Judge directed that the
379 cases be handled expeditiously, that did not preclude the Staff from requesting
380 additional time if it believed the time was needed to complete its review.

381 Although I cannot know the extent of Staff's review, I question the conclusion that
382 the review was hampered by lack of time. Consider:

- 383 • Approximately one month after the GPAA was signed in the fall of 1999,
384 Staff requested and Respondent provided a copy of the GPAA to Staff.
385 One must assume that they requested it in order to review it. Moreover,
386 Staff had the authority to request additional information about the GPAA
387 outside the context of a reconciliation proceeding. If its review of the
388 GPAA indicated a need for such additional information, it was free to
389 request it at any time.
- 390 • Staff's testimony was submitted in late May of 2001. That means that
391 Staff had in excess of 1 ½ years to review the contract before filing
392 testimony.
- 393 • Staff submitted data requests, to which the Company responded, about
394 the GPAA during the fiscal year 2000 gas charge reconciliation case. The

395 Staff's direct testimony in the 2000 reconciliation case asserted that it was
396 based on, among other things, responses to extensive data requests.

- 397 • There was no cut-off date for discovery in the 2000 reconciliation case.
398 • There was no set deadline for completing the 2000 reconciliation case.
399 • The Company, in response to comparable data requests, provided Staff
400 the same information on the GPAA in the 2000 reconciliation case as they
401 have in this case. Nothing in Staff's testimony suggests a lack of careful
402 consideration.

403 One cannot, for purposes of the integrity of this process, conclude that a contract
404 was prudently entered into in one year and then, the following year, conclude that
405 the it was imprudent to enter into the same contract. That would be an
406 unreasonable precedent for the Commission to establish. Moreover, it would
407 stand the Commission's prudence standard on its head when dealing with a
408 multi-year contract such as the GPAA. For example, the GPAA was in effect for
409 fiscal year 2002. For purposes of the proceeding for fiscal year 2002, was it
410 prudent to have entered into the GPAA in 1999, as determined by the
411 Commission in the fiscal year 2000 reconciliation proceeding, or was it imprudent
412 to have entered into the GPAA in 1999, as argued by the Staff and Mr. Effron in
413 this proceeding?

414 Q. Was there anything in Staff's testimony or the Commission order that
415 suggested the review of fiscal year 2000 gas costs was anything less than
416 thorough?

417 A. No. For example, page 2 of the Commission's Order stated: "Staff
418 witness Steven Cianfarini, a Senior Energy Engineer in the Engineering
419 Department of the Energy Division, testified as to the Commission's definition of
420 'prudence.' He then stated that, after reviewing the Company's testimony and
421 responses to extensive data requests, he did not find that the respondent made
422 any imprudent purchases."

423 Page 5 of that same order, in the Commission Analysis and Conclusions
424 section, stated: "All parties were afforded the opportunity to conduct discovery,
425 cross-examine all witnesses, and present any evidence with respect to any issue
426 in this proceeding. ... Respondent presented detailed evidence in support of the
427 prudence of the gas costs that it recovered through its PGA during the
428 reconciliation period. In evaluating this evidence, Staff used the appropriate
429 standards adopted by the Commission to review prudence, and found no
430 evidence of imprudence."

431 Finally, page 10 of the order, in the fourth ordering paragraph stated:
432 "during the reconciliation period there was no evidence to indicate that
433 Respondent had not acted reasonably and prudently in its purchases of natural
434 gas."

435 These references are important in that the GPAA had been in place during
436 the 2000 reconciliation case and the same test of prudence was used in that
437 case.

438 Q. Were Respondent's costs under the GPAA so insignificant in fiscal 2000
439 as to not require a total review during the reconciliation proceeding?

440 A. No. Respondent incurred about \$336 million in gas costs in fiscal year
441 2000 under the GPAA. These costs represented about 74% (more than the 64%
442 in 2001) of Respondent's total gas costs in fiscal 2000. As Mr. Wear discussed
443 in his additional direct testimony (page 28), the terms of the GPAA in fiscal year
444 2000 were substantially identical to the terms in effect in fiscal year 2001.
445 Neither Staff nor any party recommended any disallowances in fiscal year 2000
446 related to those or any other costs, and the Commission found that Respondent's
447 gas costs were prudently incurred.

448 **Interstate Hub Transactions**

449 Q. Dr. Rearden stated, on page 49 of his direct testimony, that "[r]atepayers
450 must wait for a future rate case and hope that the firm premiums for non-tariff
451 services make their way into the Company's above-the-line test-year revenues."
452 Is there anything unusual about this approach?

453 A. No. Dr. Rearden is simply pointing out the Commission's long-standing
454 practice. The Commission establishes base rates reflecting, very generally,
455 costs and revenues for a test year. Specific elements of costs go up and down,
456 as do revenues, but the Commission does not adjust rates based on a single
457 item. Rather, it waits until a rate proceeding and then examines all costs and
458 revenues. There are limited exceptions to this general principle. For example,
459 the Commission has authorized certain costs and revenues to be accounted for
460 in riders. Gas costs and revenues are an example. Hub revenues, however, are
461 properly considered a base rate item.

462 Dr. Rearden's statement that customers have to "hope" that the rate case
463 process will properly handle above-the-line revenues, such as hub revenues,
464 makes the process sound like a lottery. The rate case process is one with which
465 the Commission and its Staff have considerable experience and expertise.
466 There is nothing unique about hub costs and revenues that would create
467 uncertainty about the proper treatment of these costs and revenues in a rate
468 case. Hub revenues are above-the-line utility revenue and would be treated
469 accordingly.

470 Between rate cases, the Company cannot recoup increased costs that are
471 recoverable through base rates, nor is it obligated to relinquish increased
472 revenues that it may realize through more efficient use of assets. For example,
473 the Company cannot increase the cost recovery for bad debt between rate
474 cases, even though it has increased significantly since the last rate case. Both
475 base rate costs and revenues would be addressed and reviewed in the
476 Company's next rate case.

477 The Company provides quarterly reports to the Commission that provide
478 financial performance results including the Company's rate of return. These
479 returns include the benefits of hub revenue. If the Commission determined that
480 the Company's returns were out of line, they could cite the Company in for a rate
481 case. They do not have to wait for the utility to file a rate case. Because the
482 Commission has not cited the Company in for a rate case, it is reasonable to
483 conclude that the Commission does not believe that the Company's earnings
484 have not been out of line.

485 Q. Do you know if any other Illinois utility has had hub costs and revenues
486 addressed in a rate case?

487 A. Yes. Nicor Gas' last rate case addressed its "Chicago hub revenues." The
488 Commission, noting its decision in a prior Nicor Gas case related to the
489 accounting treatment of hub revenues, made an adjustment to reflect the
490 treatment of hub revenues as above-the-line. Neither the rate case nor the
491 preceding case concerning accounting treatment provided for flowing revenues
492 through the gas charge. Had Respondent been operating its Hub at the time of
493 its last rate case, it would presumably have received similar treatment.

494 Q. Mr. Lounsberry, on page 5 of his direct testimony, stated that these
495 transactions "had not come to Staff's attention prior to its review in the instant
496 proceeding." Please comment.

497 A. I am surprised that Staff takes that position. First, as I mentioned, the
498 precedent for hub transaction revenues was set in Nicor Gas' last rate case as
499 well as a Nicor Gas proceeding regarding accounting treatment of hub revenues.
500 Second, the Commission was a party to Respondent's filing at the Federal
501 Energy Regulatory Commission ("FERC") in which it sought, and received,
502 permission to implement an Operating Statement to offer certain hub
503 transactions. Respondent made this filing in November 1997 and the FERC
504 issued orders in March 1998. Third, FERC rules require Respondent to file an
505 annual transportation report and a semi-annual storage report. The FERC rules
506 require that the certificate holder serve the transportation report on its state
507 commission. Respondent serves both the transportation and the storage reports

508 on the Commission. Finally, the Commission also intervened in Nicor Gas'
509 certificate application at the FERC and at least two Nicor Gas FERC rate
510 proceedings related to its hub. There is ample reason to believe that the
511 Commission and its Staff are aware of FERC-jurisdictional transactions
512 performed by Illinois utilities, including Respondent's activity. As stated earlier,
513 the hub has been in existence since 1998, and Staff has never voiced the
514 concerns it raises in this proceeding.

515 **Audit Recommendations and Internal Controls**

516 Q. Mr. Knepler proposed that the Commission impose certain internal and
517 external auditing obligations on Respondent. Are these recommendations
518 needed?

519 A. No. First, Respondent believes that Staff is using a single mishandled off-
520 system transaction -- identified as Transaction No. 16/22 -- to bootstrap itself to
521 the conclusion that there are major flaws in Respondent's processes. Contrary
522 to Dr. Rearden's testimony (page 41 of his direct testimony), Transaction No.
523 16/22 is not, nor was it ever, representative of Respondent's practices. Second,
524 Staff's citation to hub transactions as a reason for an audit is misplaced. While
525 Staff claims not to have been aware of FERC jurisdictional transactions prior to
526 this proceeding and while Staff objects to those transactions, that has nothing to
527 do with internal controls and procedures. Third, Staff's objections to transactions
528 involving affiliated companies and various Enron entities -- but not Respondent --
529 provide no support for an audit. Fourth, an audit should consider circumstances
530 as they exist at the time of the audit and make forward looking recommendations.

531 Respondent has made improvements to its processes that obviate the need for
532 an audit based on Staff's conclusion that Respondent's practices were deficient.

533 The Company believes that a Commission imposed management audit is
534 unnecessary at this time. While the Company is always concerned with gas
535 supply documentation, analysis and internal controls, we believe that steps are
536 already underway to improve in these areas.

537 Q. Why is Transaction No. 16/22 not the basis for an audit?

538 A. The transaction and errors associated with the transaction were unique in
539 fiscal year 2001. No system can completely prevent errors or mishandled
540 transactions. Respondent makes hundreds of gas supply decisions every year.
541 Looking only to off-system transactions, there were 103 such transactions in
542 fiscal year 2001. Yet, Staff is focusing on this single transaction to paint a picture
543 of poor processes. Additionally, as described below, there have been
544 improvements in processes to avoid similar problems.

545 Q. Why are Staff's concerns about hub transactions not the basis for an
546 audit?

547 A. As stated above, Staff's concerns about the hub relate more to the fact
548 that it ignored the hub prior to this year and its incorrect belief that the hub
549 transactions adversely affect gas costs. Those concerns have nothing to do with
550 processes that would be the subject of an audit. It is inconsistent treatment of
551 the Company from prior cases.

552 Q. Why are concerns about affiliates and Enron not the basis for an audit?

553 A. Beginning with its bankruptcy filing in December 2001, no Enron wholesale
554 gas entity conducted any significant amount of business, other than winding up
555 some transactions. Respondent has conducted no business with ENA or any of
556 its affiliates since the court-approved termination of the GPAA in March 2002.
557 enovate no longer exists. Neither Respondent nor any of its affiliates entered
558 into a comparable venture subsequent to the dissolution of enovate. Given the
559 forward looking nature of an audit, the perceived concerns about Enron are
560 irrelevant.

561 Q. Please describe changes that Respondent has made subsequent to the
562 reconciliation year.

563 A. Since fiscal year 2001, the Company has taken, or is in the process of
564 taking, steps to improve its internal controls.

565 Policies and Procedures

- 566 • Restrictions have been tightened as to which personnel are authorized to
567 make gas supply deals.
- 568 • In late 2001, the Company began investigating a voice recording system
569 for use in the daily gas supply purchasing activity. In June, 2002 the Gas
570 Supply area began using such a system. These recordings are also used
571 on an as needed basis if differences of opinion are being discussed with
572 suppliers or pipelines.
- 573 • Currently, documentation gaps are being identified and Gas Supply
574 procedures are either being reviewed or developed. Processes that have

575 not yet been documented are scheduled to be completed within the next
576 six months.

577 Staffing Changes

578 • In February, 2003 a new position was created in Gas Supply
579 Administration to add emphasis on controls and analysis. The job
580 consists of identifying gas supply needs, providing analysis to support the
581 decision-making process, assisting in contract negotiations, and ensuring
582 that contracts are executed in a timely manner. In addition, the job entails
583 developing and maintaining policies and procedures for documenting and
584 recording gas supply transactions and ensuring that all executed deals
585 conform to these guidelines as well as to the terms and conditions of the
586 contract.

587 • The Gas Supply area has recently filled two positions with personnel
588 having accounting backgrounds. The Company believes this will help
589 strengthen the documentation and internal controls in the area.

590 New Software - Monaco System

591 • The Company is in the process of installing new software that will improve
592 the tracking and documenting of gas supply activity and transactions. The
593 software called "Monaco" is provided by Woodlands Technology, LLC.
594 The software is scheduled to be installed this year. The software provides
595 for capturing comprehensive transaction information, contract
596 administration, audit functionality and management reporting.

597 Sarbanes-Oxley

598 The Sarbanes-Oxley Act of 2002 requires companies to document and
599 test the business processes used to create their financial statements. Beginning
600 in 2004, when a company files its annual report, it must guarantee that its internal
601 controls have been written down and tested by outside auditors. The Gas Supply
602 Procurement process is included in this review. The Company has assembled a
603 project team to assure that the Company meets these requirements.

604 Given the scope of the Sarbanes-Oxley project, the Company believes
605 that a second audit by the Commission may unnecessarily duplicate and add
606 costs to the work being done for Sarbanes-Oxley compliance. Therefore, the
607 Company proposes to submit to Staff a report that addresses Staff's concerns
608 one year from the date of an order in this proceeding; that time frame allows for
609 the above activities to be completed.

610 **Intercompany Services Agreement**

611 Q. Mr. Knepler testified that certain transactions were inappropriate because
612 the Commission did not approve them. For example, he mentioned a transaction
613 with enovate (page 30 of Mr. Knepler's testimony). Please comment.

614 A. Whether a particular transaction requires Commission approval is a legal
615 issue, and Respondent will refute these allegations in its briefs. However, I note
616 that it is unclear to what transactions Mr. Knepler is referring. For example, if he
617 is talking about enovate's purchase of FERC Operating Statement services from
618 Respondent, I am advised by counsel that such transactions do not require
619 Commission approval and are not conducted pursuant to the intercompany
620 services agreement.

621 Q. Mr. Knepler cited, on page 33 of his direct testimony, a particular
622 supplemental agreement associated with the intercompany services agreement
623 and stated that the Commission had not approved it. Please comment.

624 A. Again, this is a legal issue, and Respondent will refute these allegations in
625 its briefs.

626 Q. Does this conclude your rebuttal testimony?

627 A. Yes, it does.